Moscow Financial Weekly

For the week ending January 30, 2004
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- S&P upgrades Russia's foreign-currency and domestic-currency sovereign ratings
- GOR to sell LUKoil stake in 2004
- Mortgage market gathers strength: government builds institutions, participants organize

Key Economic Indicators

Indicators	Level	chg 1 week	chg since Jan. 1	chg 12 months
RUB/USD (MICEX) UTS (changes in %)	RUB 28.5004	0.24	2.78	10.47
RUB/EUR (changes in %)	RUB 35.6060	2.03	3.31	-2.91
Monetary Base* (changes in %)	RUB 1384.2 bln	-0.08	-0.57	52.14
CPI	NA	NA	NA	NA
International Reserves* (billions)	USD 82.7	USD 3.6	USD 4.9	34.6
RTS Index (changes in %)	611.10	-2.20	7.73	76.32
Urals Crude (changes in %)*	USD 29.50	-0.71	7.50	7.50
JPMorgan EMBI+ RUS spread (changes in bp)	255	15	-2	-165
CBR Time Deposits Two-week term (changes in bp)	1.3	NA	NA	

*For one week prior

Economic Developments

The rating agency Standard&Poor's upgraded the Russian long-term foreign currency **sovereign credit rating** from BB to BB+ last week. The market was hoping for a two-step increase, which would have brought Russia to investment grade, but this action brings Russia only to the highest speculative grade. S&P attributed the upgrade decision to stable growth in

Russia's macroeconomic parameters, government budget surpluses and continuously decreasing levels of external debt. S&P is considered to have a conservative attitude toward Russia, as opposed to Moody's, which increased Russia's sovereign rating by two notches in October of last year, bringing it to investment grade. S&P didn't announce any forecast as to when Russia might be elevated to investment level in the foreign-currency debt area, noting that more political and economic reforms are necessary for that. The third rating agency, Fitch, announced that it might upgrade Russia's foreign debt rating to investment-grade in the middle of this year, some time after the Presidential elections. It would be beneficial for Russia to have an investment grade rating from two of the three main rating agencies, as many investment funds, as a matter of policy, require two different agencies' confirmation of a market's investment-grade status in order to start allocating money there. S&P also upgraded Russia's sovereign rating in domestic currency to BBB- (from BB+), which corresponds to investment grade. This is good news for potential corporate ruble-bond issuers, as it could indirectly lead to a lower cost of borrowing.

Goskomstat announced data on the main **economic developments** in Russia in 2003 (see table below). The most positive result is the 12.5% increase in capital investment for the year. This, coupled with high world natural-resource prices, helped increase industrial production by 7%, which is the highest level seen in the past 3 years. Higher growth has only been recorded in 2000, when production was up by 12% for the year. Economic growth was also stimulated by a rapid increase in domestic consumption: retail trade turnover was up by 8% and real incomes increased by 12.5% for the year. Based on an MEDT estimate, GDP was up 7% for the year. Of this 7%, the Ministry attributes 2% to increased natural-resource prices, 0.5% to the low comparative base in 2002, and 4.5% to higher domestic consumption and capital investments growth.

	2001	2002	2003
Real GDP (% y-o-y)	5.1	4.7	7.3
Industrial Production (% y-o-y)	4.9	3.7	7.0
Capital Investments (% y-o-y)	8.3	2.5	12.5
Inflation (% y-o-y)	18.8	15.1	12.0
Real Incomes (% y-o-y)	8.5	10.1	14.5
Retail Trade T/O (% y-o-y)	10.6	9.0	8.0

Direct Investment into Russia last year totaled USD 72 billion, according to Deputy Prime Minister (and Finance Minister) Aleksey Kudrin. Although foreign direct investment (FDI) totaling USD 6.5 billion made up just a small share of total investment, Kudrin stressed, the pace of its growth was quite impressive: FDI went up by 62% in 2003. He added that the GOR expects the same positive FDI dynamics over the next few years. Earlier, the CBR had reported an outflow of FDI into the sector of non-financial enterprises (i.e. banks, etc. excluded) for 2003 in the amount of USD 0.3 billion, but also noted that H2 statistics were distorted by “a number of uncompleted transactions related to mergers and acquisitions of domestic companies”, a likely reference to the Yukos-Sibneft affair.

The government plans to sell its 7.6% stake in **LUKoil**, the second largest oil company in Russia, by the end of June 2004. The government expects to sell its whole stake if stock market conditions are favorable, but if prices are lower than expected levels, it will sell only a portion of its shares. The sale would take place on the domestic market. According to legislation, companies can issue no more than 40% of their capital in the form of depository receipts, and LUKoil already has 57% of its shares traded in the form of the ADRs. (The law came into effect after LUKoil had already issued the ADRs.)

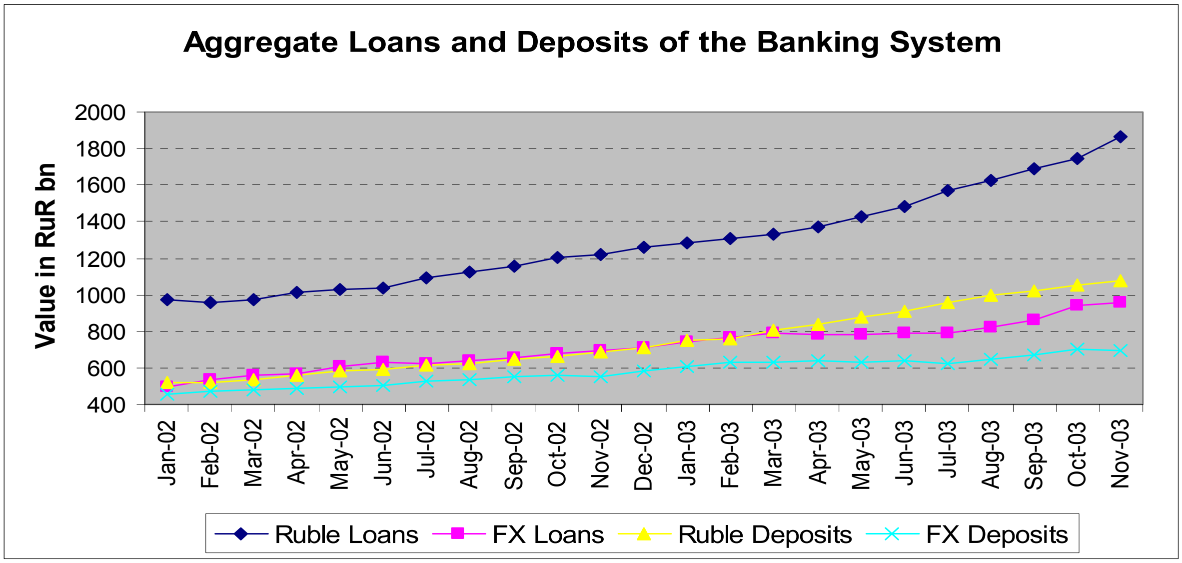
Banking sector

A conference entitled "Banks on the Market for Mortgage Lending" took place in Moscow on January 27. Garegin Tosunian, President of the Association of Russian Banks (ARB), told the conference that by the end of 2007, banks are expected to issue at least USD 2 billion worth of **home mortgage loans**, compared to about USD 500 million as of now. According to the ARB, there are 146 banks doing mortgage lending in the Russian market. Sberbank accounts for about 50% of all mortgage loans, followed (with a significant gap) by Delta Credit, Raiffeisenbank, Gazprombank, VTB and Sobinbank. Last year the average size of a loan was RUB 530 thousand (about USD 17.3 thousand) and the average term was 10 years. Andrey Kozlov, CBR First Deputy Chairman, said that this spring the CBR plans to prepare an instruction with special prudential norms for banks issuing mortgage securities. The capital adequacy norm for mortgage banks will be set at 14% (versus 10% for all the rest). Moreover, new norms will be introduced specifically for mortgage banks: the ratio of household deposits to total liabilities may not exceed 50%, and the value of the bank's portfolio of mortgages may not be less than the total value of securities issued and be greater or equal to 10% of bank capital. Aleksandr Semenyaka, General Director of the Agency for Housing Mortgage Lending (AHML), promised to lower the rate at which AHML refinances mortgages (currently 15%). The AHML raises funds for refinancing mortgages through issuing bonds. In 2003, the AHML issued RUB 1.08 billion worth of bonds. In the first half of 2004, the AHML should issue RUB 1.5 billion worth of corporate bonds, Semenyaka said, and right after the placement the refinancing rate could be reduced. He also said that in H2, the AHML might issue mortgage securities and then the total value of AHML issues might reach RUB 6 billion.

The next day, January 28, a non-profit partnership called **National Association of Mortgage Market Participants** (NAMMP) was founded by the ARB, the All-Russian Insurers Union, the National Association of Capital Market Participants, the Union of Industrialists and Entrepreneurs and a few other organizations. Vladimir Ponomarev, the Deputy Chairman of Gosstroy (State Committee for Construction), said that the NAMMP should become "a forum for drawing up a unified, coordinated position towards the development of the mortgage business".

According to CBR First Deputy Chairman Andrey Kozlov, the long-awaited revised version of the **Joint GOR-CBR Banking Strategy** will be discussed by the GOR on February 11. Kozlov said in an interview that the Strategy was approved by the CBR Board on January 30. The stated primary goals are to launch the deposit insurance program and to adopt international accounting standards. The document stipulates that the Deposit Insurance Agency (DIA) will become the sole bank liquidator. Kozlov noted that in an amendment to the bank bankruptcy bill that passed the first reading in the Duma last year ARCO was named as the bank liquidator. There was too much opposition to that amendment, so it did not reach the second reading. Empowering the DIA to liquidate banks may be just as difficult.

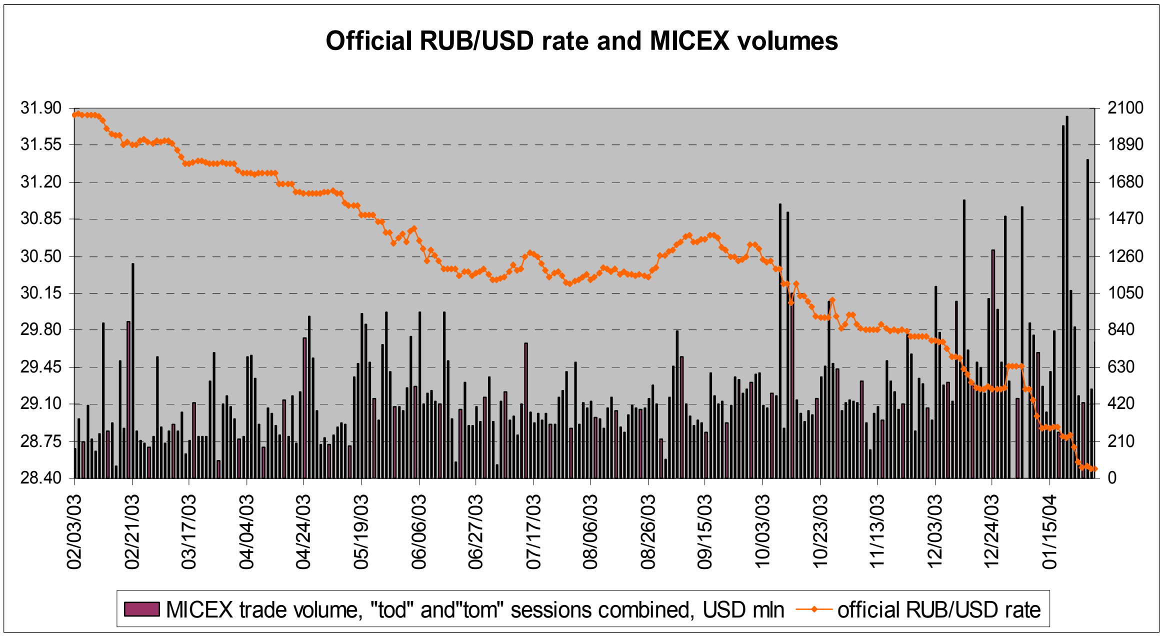
In another interview, Kozlov said that a number of regional banks had already applied for inclusion into the new **deposit insurance system**. The deadline for applications is June 28, but Kozlov expects that the majority of banks will apply in April-May.



Financial markets

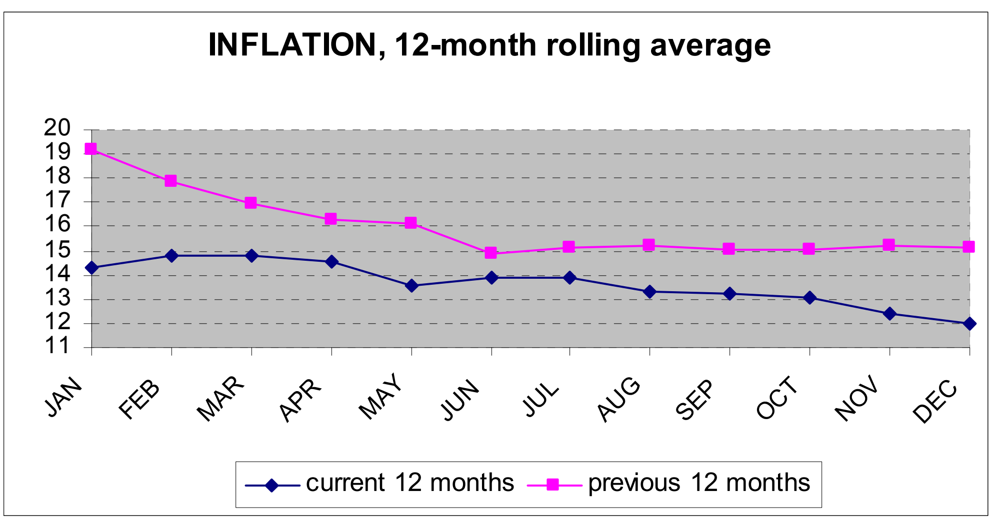
Forex Market

The forex market was very calm during the first half of the week, with the RUB/USD rate fluctuating in a narrow band limited by the CBR bid at RUB 28.4850/USD. The CBR did not have to buy many dollars, so total MICEX trade volumes fell to USD 430 million by Wednesday. However, on Thursday, banks launched another massive attack on the dollar, provoked, probably, by the CBR information that during the week ending January 23, reserves had increased by USD 3.6 billion. However, the CBR did not falter, and bought at least USD 1.2 billion at the same rate, RUB 28.4850/USD. As a result, the next day banks found themselves “oversold” and had problems financing their short positions, and the dollar, for the first time since January 21, actually slightly firmed against the ruble.



Prices

Goskomstat Chairman Vladimir Sokolin forecasts a spike in the inflation rate in January. Inflation traditionally is high in January due to seasonal factors such as higher consumer spending during the holiday season and a spike in services prices. In January, heating and communal housing services prices and transportation tariff increases were the main factors causing the spike. First Deputy Chairman of the CBR Oleg V'yugin forecasts January inflation to be around 2-2.1%. This doesn't yet threaten the annual governmental forecast of 10% for 2004, but may be a signal for the CBR to be careful in supporting the dollar on the domestic market. In 2003, January inflation was 2.4%, while services prices increased by 8% for the month.

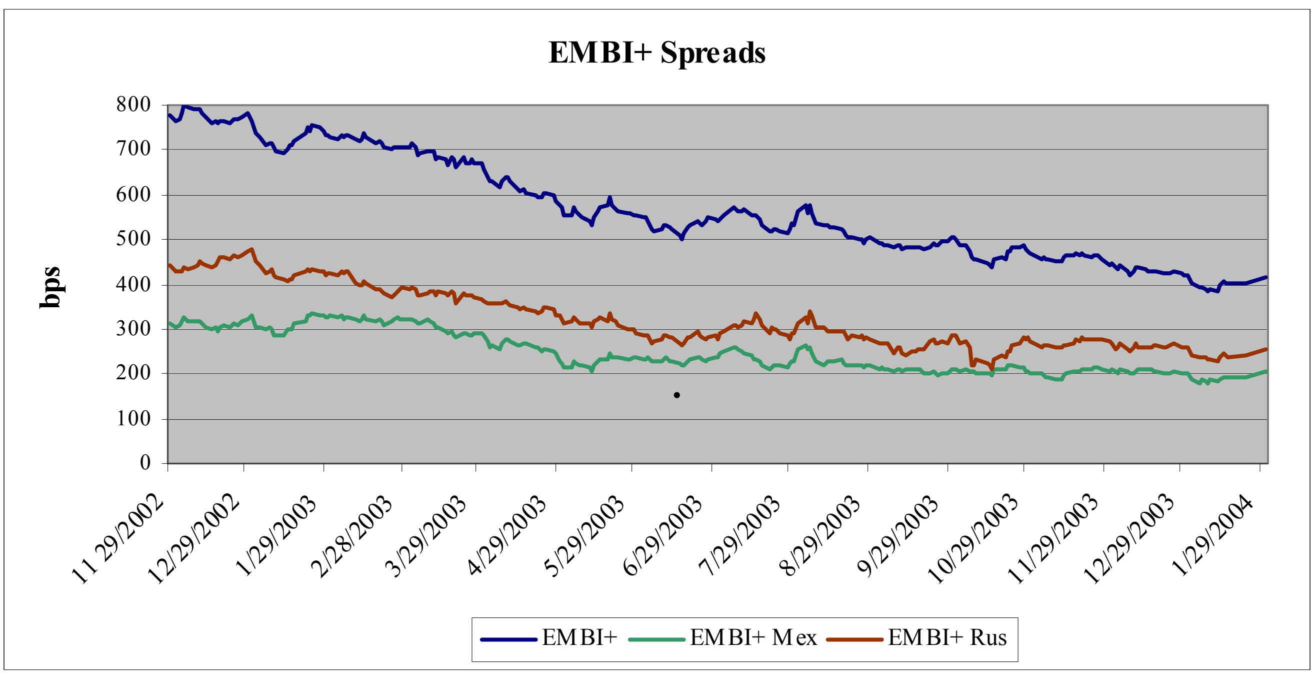


<u>Eurobonds</u>

Bank Petrocommerce (rating "B" from S&P), owned by LUKoil, made a Eurobond placement last Friday. The bank issued Eurobonds for a total sum of USD 120 million with a maturity of three years and the yield of 9%. Last year the bank postponed the issuance, waiting for more favorable conditions on the market. The issue is traded close to the 2006 Bank Zenit Eurobonds, which currently trade at a yield of 9% p.a.

The Russian Eurobonds sector fell slightly last week. The news about the S&P increase of the Russian sovereign rating slightly revived the market, but toward the end of the week prices started to slide again. The most liquid Russian Euro-30 price dropped from 99% of par in the beginning of the week to close at 97% of par by the end of the week.

COMPONENT	COMPONENT SPREAD & DATE				SOVEREIGN RATING		
JPMorgan's		01/23/04	12/29/03	01/22/03	S&P	Moody's	Fitch
EMBI Russia	255	240	259	420	BB+	Baa3	BB+
EMBI+	414	401	425	731	N/A	N/A	N/A
EMBI Brazil	489	426	480	1368	B+	B2	B+
EMBI Mexico	205	195	203	325	BBB-	Baa2	BBB-
EMBI Turkey	319	286	312	693	B+	B1	B



Bonds/Bills

The Moscow city government successfully placed bonds for a total amount of RUB 4.9 billion last week. The demand for Moscow-38 exceeded the supply by a factor of 3.7. The S&P decision on the Russian rating upgrade added to the positive attitude toward the issue. It made it possible to place the bonds with an average-weighted yield of 8.23% p.a. instead of the 9.05% p.a. forecasted by the Government. Later in the week, the yield moved down to 8.1% on the secondary market, which also shows stable demand for quality ruble instruments.

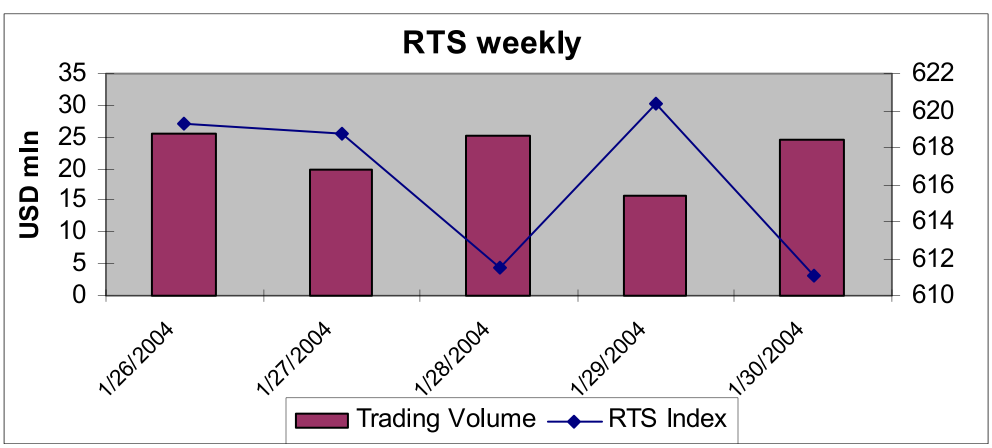
The secondary OFZ/GKO market was silent on Monday, but on Tuesday the situation reversed when the news about the S&P increase of the Russian sovereign rating for ruble debt entered the market. Trading activity and volumes increased substantially. On Wednesday, the rally on the secondary market was fueled by excess money which entered the market after the auction of the Moscow bonds.

Overnight rates

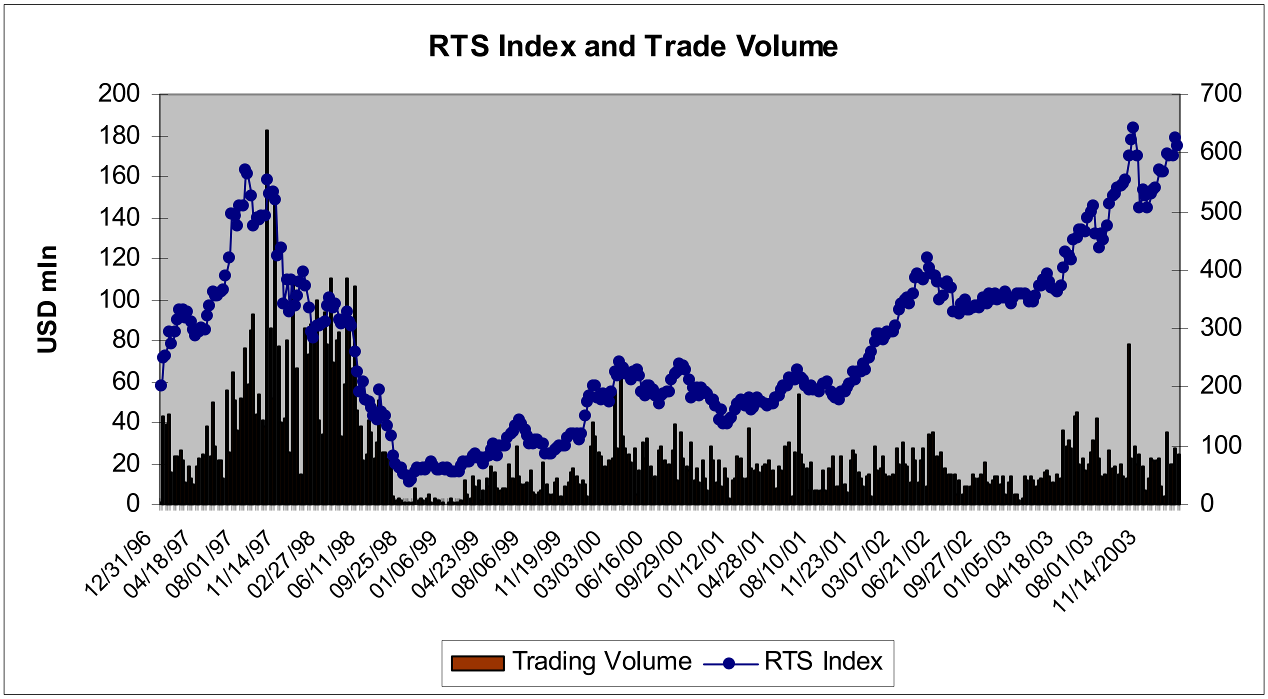
Balances on banks' correspondent accounts at the CBR were fluctuating on rather high levels throughout the week, increasing on Friday by RUB 40.2 billion for a total of R256.8 billion, which is explained by the seasonal tax payments made by banks for their clients. Overnight ruble loan rates were slightly below the levels seen during the previous week fluctuating in the range of 1-1.2% p.a. throughout the week.

Stock Market

The Russian stock market started the week down and experienced three straight sessions of downward movement, after having pierced through the serious resistance level of 620 points the week before. The market successfully revived on Thursday, but on Friday some negative news about RAO UES entered the market and prices started to fall again. The MEDT had suggested to both sell the shares of the Wholesale Generating Companies and allow them to be exchanged for RAO UES shares. The market price of RAO UES shares had implied only the second scenario, and so the shares lost around 5.2% for the day, while the RTS index decreased by 1.5% on Friday. The RTS index was down by 2.2% for the week on moderate volumes.



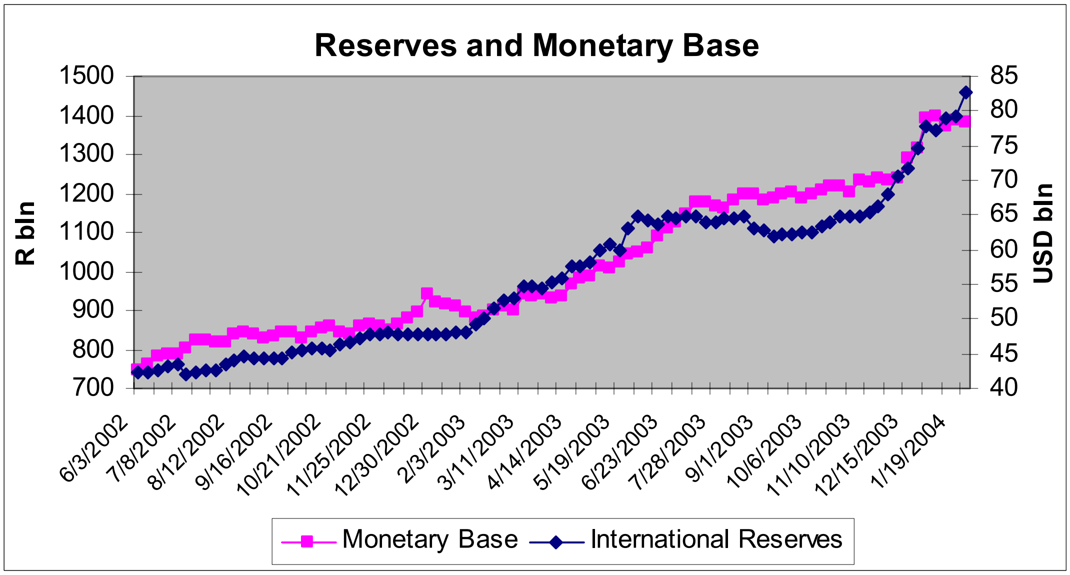
For the week ending January 30, 2004



International Reserves and Monetary Base

The international reserves of the CBR and Finance Ministry spiked up by as much as USD 3.6 billion for the week, reaching another record of USD 82.7 billion as of January 23. This is the highest weekly increase since the crisis of 1998. A technically higher increase was recorded in the middle of July 1998, when reserves were up by USD 5.6 billion: however, this was due to a large disbursement of IMF money that month. By contrast, the increase of the week of January 19th is explained mostly by CBR interventions on the domestic currency market. Russia currently has the fourth highest level of international reserves in the world, after Japan, China and Euroland.

The monetary base slightly decreased and as of January 26 totaled RUB 1,384.2 billion which is RUB 1.1 billion (0.08%) lower than a week before.


Reserves and Monetary Base
R bln
USD bln
1500
1400
1300
1200
1100
1000
900
800
700
85
80
75
70
65
60
55
50
45
40
6/3/2002
7/8/2002
8/12/2002
9/16/2002
10/21/2002
11/25/2002
12/30/2002
2/3/2003
3/11/2003
4/14/2003
5/19/2003
6/23/2003
7/28/2003
9/1/2003
10/6/2003
11/10/2003
12/15/2003
1/19/2004
Monetary Base
International Reserves

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell repatriated currency. Minimum lot size for each of the dollar instruments is USD100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. **INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. **MONETARY BASE** (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.

7. **JPMORGAN EMERGING MARKETS BOND INDEX PLUS** (EMBI+) tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ may be separated into individual components (such as by sovereign issuer). The source of all EMBI+ data in this publication is JPMorgan.

8. **CBR TIME DEPOSIT RATE** is set by periodic auctions held by the CBR that allow banks to hold money there at fixed terms for interest. The interest rate is set by the auction process, but the CBR sets the terms, which range from one week to several months and are not always the same at each auction. The benchmark time-deposit rate we will try to use is the shortest one. These auctions are not necessarily held on a regular weekly basis, so some data related to this indicator may not always appear in the Financial Weekly.